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Allowance of Claims or Interests

Attorneys Matt J. Williams and Matthew K. Kelsey of Gibson, Dunn & Crutcher, New York, analyze the Fifth Circuit's recent decision in *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, which recognized the court's ability to recharacterize non-insider loans as equity, and opine that the case is important because it provides a straightforward analytical framework that should assist both practitioners and bankruptcy courts in determining whether and under what circumstances debt can be recharacterized as equity.

Debt Recharacterization Under *Lothian Oil*

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I. Introduction

Bankruptcy courts oversee the claims reconciliation process under Bankruptcy Code Section 502. Yet Supreme Court precedent directs the federal courts to look to applicable *state* law—not bankruptcy law—to determine whether a claim will be allowed or disallowed.[1] In its recent decision in the *Lothian Oil* bankruptcy case,[2] the Fifth Circuit took this direction a step further and utilized state law to determine whether a non-insider claim would be recharacterized as an equity infusion in the bankrupt entity. Although the result reached by the court (i.e., recognizing ability to recharacterize non-insider loan as equity) is consistent with that of some (but not all) of the other bankruptcy courts that have ruled on the issue, the method—analyzing state law to determine whether recharacterization is proper—is fundamentally different from the approach previously taken by almost all bankruptcy courts, which have to date recharacterized loans based on the general equitable powers conferred upon bankruptcy courts pursuant to Section 105 of the Bankruptcy Code.

II. The Doctrine of Recharacterization

Under Section 726 of the Bankruptcy Code, debt claims are entitled to payment before equity ownership interests. Therefore, if a loan is "recharacterized" as an equity infusion, the practical effect is that the money

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[1] *See, e.g., Travelers Cas. & Sur. Co. of Am. v. Pac. Gas & Elec. Co.*, 549 U.S. 443, 450-51 (2007); *Butner v. United States*, 440 U.S. 48, 54 (1979).

[2] *Grossman v. Lothian Oil Inc. (In re Lothian Oil Inc.)*, 650 F.3d 539 (5th Cir. 2011)(23 BBLR 1027, 8/25/11).

advance in question is subordinated to all debt claims in the bankruptcy case. But unlike the power to equitably subordinate a claim (which is expressly granted to the bankruptcy court pursuant to Section 510(c) of the Bankruptcy Code based on the inequitable conduct of the claimant), the Bankruptcy Code confers no express power to a bankruptcy court to recharacterize claims as equity interests. Rather, bankruptcy courts have typically relied on the equitable powers conferred to them pursuant to Section 105 of the Bankruptcy Code to subordinate claims to the level of equity.

In performing the analysis, bankruptcy courts will generally look to substance over form. For instance, if the parties to the transaction called the funds advance a ''loan,'' but the advance bears the typical features of an equity investment, a bankruptcy court will usually not allow itself to be bound by the title used by the parties, but may recharacterize the advance as an equity infusion. Generally derived from case law from federal tax cases (where, for the purposes of federal tax, there are significantly different tax ramifications depending on whether a transaction is a loan or an equity investment),[3] factors bankruptcy courts typically look to include, depending on the relevant Circuit, the following: (a) the names given to the instruments; (b) the presence or absence of a fixed maturity date; (c) the presence or absence of a fixed rate of interest and interest payments; (d) the source of repayments; (e) the adequacy or inadequacy of capitalization; (f) the identity of interest between the creditor and the stockholders; (g) the security, if any, for the advances; (h) the corporation's ability to obtain financing from outside lending institutions; (i) the extent to which the advances are subordinated to outside creditors; (j) the extent to which the advances are used to acquire capital assets; (k) the presence or absence of sinking fund payments; (l) participation in management flowing as a result of the infusion; (m) the intent of the parties; and (n) certainty of payment in event of corporation's insolvency or liquidation.

Based on the powers granted pursuant to Section 105, and using some or all of the above-referenced factors, recharacterization has been considered a viable defense to a claim in at least the Third, Fourth, Sixth, and Tenth Circuits.[4] The Eleventh Circuit also recognizes the ability of a bankruptcy court to recharacterized debt as equity, but has adopted a far less flexible approach than other Circuits, holding that an insider debt should be recharacterized as a capital contribution if (a) the company was undercapitalized at the time the loan was made or (b) no outside party would have made the loan.[5] The Ninth Circuit Bankruptcy Appellate Panel, by contrast, has ruled that a bankruptcy court lacks authority to recharacterize debt as equity because recharacterization is, in essence, subordination, which is governed by Bankruptcy Code Section 510(c) and, therefore, requires a showing of inequitable conduct.[6]

In *Lothian Oil*, however, the Fifth Circuit rules that a bankruptcy court can—and indeed must—recharacterize a claim for debt as equity using Section 502(b)(1) of the Bankruptcy Code as the statutory predicate for the bankruptcy courts' power. In so ruling, the Fifth Circuit, by focusing on the phrase ''applicable law'' contained in Section 502(b)(1) (and Supreme Court precedent that provides guidance as to what ''applicable law'' means in the context of Section 502(b)(1)), looks to the state law that governs the transaction in question to determine whether and to what extent debt can be recharacterized as equity.

III. Lothian Oil History

In the spring 2005, Israel Grossman and the secretary of Lothian Oil Inc. signed a handwritten document recognizing that Grossman had loaned Lothian $200,000. Although the parties titled the investment a loan, it had many of the hallmarks of an equity investment. For instance, rather than pay a stated interest rate, Lothian agreed to pay Grossman a 1% royalty on the production of certain oil properties. The parties further agreed that Lothian would repay Grossman the $200,000 principal from the proceeds of any equity placements made in the company, rather than have a fixed maturity date or other typical terms of repayment. Less than a month later, Grossman loaned Lothian another $150,000 in exchange for an additional 1% royalty. Akin to the original $200,000 loan, the parties agreed that the additional $150,000 loan would also be repaid from the proceeds of any equity placements made in the company. Again, there was no stated rate of interest, terms of repayment, or maturity date. Neither of the loans contained any security agreement or collateral.

In the summer of 2007, Lothian filed for Chapter 11 protection. Roughly a year later, the bankruptcy court confirmed a liquidating plan. Pursuant to the plan, holders of equity interests were not entitled to any recovery. In the bankruptcy proceedings, Grossman asserted numerous claims against the company. Pursuant to a settlement agreement approved by the bankruptcy court, Grossman received $1.025 million on account of certain claims and further retained the ability to seek allowance of (and payment pursuant to the plan on) numerous other claims, including the claims related to the $350,000 in ''loans'' advanced to Lothian two years prior to the bankruptcy case. The debtor objected to these claims on the grounds that they were disguised equity infusions. The bankruptcy court agreed, holding that the related proofs of claim ''assert common equity interests at best and that insufficient evidence of the value of the interests was presented.''

Grossman appealed to district court. The district court cited an 11-factor test previously used in the Fifth Circuit for distinguishing debt versus equity (including most of the factors described above utilized by most Circuit Courts), but ultimately reversed the bankruptcy court with respect to the recharacterization of the $350,000 loans as equity infusions. Instead, the district court noted that the doctrine of recharacterization was typically only applied to insider creditors and that it would therefore ''decline to extend the concept of debt

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[3] *See*, *e.g.*, *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 630 (6th Cir. 1986), *cert denied*, 481 U.S. 1014 (1987).

[4] *See Cohen v. KM Mezzanine Fund II LP (In re SubMicron Sys. Corp.)*, 432 F.3d 488 (3d Cir. 2006); *Fairchild Dornier GmbH v. Official Comm. of Unsecured Creditors (In re Official Comm. of Unsecured Creditors for Dornier Aviation (North America), Inc.*, 453 F.3d 225 (4th Cir. 2006); *Bayer Corp. v. MascoTech, Inc. (In re AutoStyle Plastics, Inc.)*, 269 F.3d 726, 748-49 (6th Cir. 2001); *Sender v. Bronze Group, Ltd. (In re Hedged-Invs. Assocs., Inc.)*, 380 F.3d 1292 (10th Cir. 2004).

[5] *See Estes v. N&D Props., Inc. (In re N&D Props., Inc.)*, 799 F.2d 726, 733 (11th Cir. 1986).

[6] *See In re Pac. Express, Inc.*, 69 B.R. 112 (9th Cir. BAP 1986).

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recharacterization to a non-insider creditor.'' Lothian appealed to the Fifth Circuit.

On appeal, the Fifth Circuit reversed the district court. First, the Fifth Circuit criticized the *per se* rule proposed by the district court, which would limit recharacterization to corporate insiders only. Barring any applicable law to the contrary, the Fifth Circuit stated that the bankruptcy court was required to examine the question of whether or not the capital infusions were properly characterized as debt or equity regardless of the ''insider'' status of the lender.

Second, the Fifth Circuit recognized that, to the extent bankruptcy courts recharacterized loans as equity infusions, they typically did so pursuant to the equitable authority granted under Section 105 of the Bankruptcy Code, which gives a bankruptcy court wide latitude to issue orders or enter judgments ''necessary or appropriate to carry out provisions'' of the Bankruptcy Code. The fact that the Fifth Circuit generally takes a ''cautious'' view of Section 105 and its concomitant powers was of no concern, the court held, because a different provision of the Bankruptcy Code—to wit, Section 502(b)— expressly authorized the bankruptcy court to allow or disallow claims asserted against the estate. Therefore, the Fifth Circuit disregarded as unnecessary an analysis of the breadth of Section 105 relative to the bankruptcy court's ability to recharacterized debt as equity.

Bankruptcy Code Section 502 provides that ''the court, after notice and a hearing, shall determine the amount of such claim, . . . and shall allow such claim in such amount, except to the extent that – (1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law. . . .'' 11 U.S.C. § 502(b). Because the ''applicable law'' referenced in Section 502(b) is state law pursuant to relevant Supreme Court precedents, and because Texas law governed the agreements in question, the Court held that Texas law should govern whether or not the $350,000 in ''loans'' should be treated as equity under the plan.

Texas state law on recharacterization uses a multifactor approach borrowed from federal tax law—an approach similar to that originally used by the bankruptcy court to determine whether the claim asserted by Grossman was a debt claim. Noting the lack of maturity date or repayment terms, and the fact that the only purported due was based on a rate tied to royalty payments dependent on the success of Lothian's business, the Fifth Circuit held that, under Texas state law, a court would not recognize Grossman's claims as asserting a debt interest, and therefore the bankruptcy court had correctly disallowed them as debt and recharacterized them as equity. ''Moreover,'' the court stated, ''because insiders and non-insiders alike can mischaracterize their claims in contravention of state law, we decline to limit recharacterization to insider claims.''

IV. Analysis of Lothian Oil Case and Its Potential Impact

Lothian Oil is an important development in bankruptcy law, not only because the Fifth Circuit has rejected a *per se* rule that all debt recharacterizations must involve a loan from an insider. *Lothian Oil* is more important because it provides a straightforward analytical framework that should assist both practitioners and bankruptcy courts in determining whether and under what circumstances debt can be recharacterized as equity. The analytical approach adopted by *Lothian Oil* is consistent with the plain meaning of Section 502(b)(1) of the Bankruptcy Code and applicable Supreme Court precedent. Although its adoption may cause some confusion and inconsistent results (insofar as different state laws have different recharacterization standards), it avoids an absurd result where a claim that would otherwise be deemed equity under state law would be elevated to claimholder status solely by virtue of the bankruptcy filing.

As discussed above, Section 502(b)(1) of the Bankruptcy Code provides that a bankruptcy court shall allow a claim except if ''such claim is unenforceable against the debtor and property of the debtor[] under . . . applicable law.'' By its terms, Section 502(b)(1) means that a bankruptcy court cannot allow a claim asserted against a debtor if the amount asserted is unenforceable against the debtor under state law. Accordingly, if applicable state law provides that a debt is not an enforceable debt in any amount because the claim should be recharacterized as an equity contribution, Section 502(b)(1), by its terms, specifically precludes bankruptcy courts from allowing the claim. As stated by the Supreme Court, the ''basic federal rule in bankruptcy is that state law governs the substance of claims, Congress having generally left the determination of property rights in the assets of a bankrupt's estate to state law.''[7]

But if a bankruptcy court cannot allow a claim that application of state law would require to be recharacterized as equity, does Section 502(b)(1) authorize a bankruptcy court to recharacterize the claim, or must the advance be expunged in its entirety? As a practical matter, because equity interests are often not entitled to any recovery in a bankruptcy proceeding, disallowance versus recharacterization is a distinction without a difference—either way, the holder of the claim will be entitled to no recovery.

Nonetheless, to the extent the distinction between disallowance and recharacterization is relevant in a particular case (i.e., if equity holders are entitled to a recovery), the Code appears to allow for the court to recharacterize the advance as an equity interest. Notably, Section 502(b)(1) only prohibits the allowance of a ''claim'' that is unenforceable against the Debtor. It does not by its terms preclude the recognition of an enforceable equity interest related to the disallowed claim. Indeed, a simple remedy in this situation would be for the court to deem the recharacterized claim filed as an interest under Section 501(a) (or in the alternative, for the purported creditor to file a proof of interest under that section of the Code).

The fact that Congress has not expressly barred or limited recharacterization (pursuant to Sections 510(b), 510(c), or in any other provision of the Bankruptcy Code) is telling because, Congress expressly prohibits recharacterization of certain kinds of debt in other, analogous circumstances.

For example, looking to relevant state law to determine whether to recharacterized debt into equity is consistent with recharacterization in other contexts. Specifically, bankruptcy courts typically analyze state law (in this case, the Uniform Commercial Code) to determine whether a lease should be ''recharacterized'' as a true sale. However, regardless of the economic terms of

[7] *Travelers*, 549 U.S. at 450-51 (citations omitted).

the transaction, per Section 1110 of the Bankruptcy Code, Congress specifically prohibits the bankruptcy court from recharacterizing a lease for aircraft equipment and vessels as a financing, so long as the purported lease states on its face that it should be treated as a lease for federal income tax purposes. The legislative history makes clear that the purpose of this provision was to provide a safe harbor from recharacterization. Given clear Congressional mandates in other provisions of the Bankruptcy Code, the absence of a specific statutory mandate from Congress to the contrary strongly implies that a bankruptcy court *does* have the power in other circumstances to recharacterize debt. Accordingly, a fair reading of Section 502(b)(1) is that it provides a bankruptcy court with the latitude to recharacterize a debt claim as equity if recharacterization is permitted (or mandated) by state law.

Analyzing whether a debt should be recharacterized under state law also avoids certain problems with using either Section 105(a) or Section 510(c) to recharacterize claims that are, in essence, equity. For instance, with respect to Section 105(a), as *Lothian Oil* noted, in jurisdictions like the Fifth Circuit, courts are required to go through a comprehensive analysis to determine whether authority exists under Section 105(a) for a bankruptcy court to exercise a particular power. Furthermore, under a strict reading of Section 105(a), one might argue that Section 105(a) alone cannot give a bankruptcy court a power it does not already have under another provision of the Bankruptcy Code.[8] Similarly, although Section 510(c) of the Bankruptcy Code authorizes a bankruptcy court to subordinate some or all of a claim under principles of equitable subordination, recharacterization is an entirely different remedy. Courts generally (and correctly) hold that Section 510(c) only allows subordination of debt based on bad behavior. Subordinating a claim to other claims as a punitive measure is quite different than recharacterizing debt for equity, which is not punitive, but rather is an exercise to look through the form of an agreement and identify its true economic reality.

[8] For instance, in *In re Official Committee of Unsecured Creditors for Dornier Aviation (North America), Inc.*, the Fourth Circuit ruled that the bankruptcy court had the power to recharacterize debt into equity even without any grounds to subordinate the debt under Section 105 of the Bankruptcy Code. To get there, however, the Fourth Circuit had to couple the broad powers afforded to the bankruptcy court under Section 105(a) of the Bankruptcy Code with Section 726 of the Bankruptcy Code (which establishes the general priority of distributions) and Section 510 of the Bankruptcy Code (which authorizes a bankruptcy court to subordinate debt and, thereby, disrupt the priorities established in Section 726. Thus, the Fourth Circuit ruled that Section 105(a) provides a bankruptcy court with the authority to recharacterize debt into equity only by coupling the power under Section 105(a) with other provisions of the Bankruptcy Code.

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In short, *Lothian Oil* provides practitioners with an additional argument to seek to recharacterize debt as equity. *Lothian Oil* might first seem wholly advantageous for those who would seek to challenge a claim, inasmuch as it clearly states that loans advanced by non-insiders are not immune from attack. But *Lothian Oil* does require a close examination of the state law applicable to the arrangement between the creditor and the debtor. Indeed, depending on what state law is applicable to the transaction, even the same bankruptcy court could be required to look to a wholly different set of factors for different transactions. For instance, certain states, such as California, Hawaii, Massachusetts, Oregon, Rhode Island, Washington, and Wisconsin, have well-developed case law and/or statutes regarding recharacterization. Others, like New York, as a general matter will likely look through the form of a transaction to correctly identify the economic substance. The differing law among the states, however, is no reason to adopt a different approach. To the contrary, ''[t]he Supreme Court has made it clear that the constitutional requirement for uniformity in bankruptcy laws does not preclude the Bankruptcy Code from incorporating state laws which may impact the bankruptcy process and may lead to different results in different states.''[9]

[9] *Fishbach v. Simon (In re Simon)*, 311 B.R. 641, 645-46 (Bankr. S.D. Fla. 2004).

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